MURPHY EXPLORATION AND PRODUCTION CO.

IBLA 97-8 Decided April 30, 1999

Appeal from a Decision of the Associate Director for Policy and Management Improvement, Minerals Management Service, denying an order to pay royalties on "Demand Charge" proceeds and conduct a restructured accounting. MMS-93-0889-OCS.

Affirmed.

1. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

   Where lessee has the right to suspend deliveries to gas purchaser if price falls below stated price; the demand charge is reduced to the extent deliveries are not made to purchaser; where there is no exclusive commitment of gas reserves to the lessee's purchasers under the contracts; the commodity charge component of the gas price is less than the spot market price for gas; and the effect of the demand charge and commodity charge formulae is a volume discount for gas delivered, the demand charge component of price is not the same as a take-or-pay payment.

2. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally

   Where record on appeal shows that payment of the demand charge depended on deliveries of gas volumes, and the final price of gas was determined at the end of the month when appellant computed the exact volumes taken, and where the commodity charge component of the unit price alone is less than the spot market price for natural gas, the charge is not a true demand charge, but is merely a mechanism for computing a price for production. The demand charge component of the lessee's price for gas production was properly treated as part of the lessee's gross proceeds for royalty purposes.

3. Federal Oil and Gas Royalty Management Act of 1982: Royalties--Oil and Gas Leases: Royalties: Generally--Outer Continental Shelf Lands Act: Oil and Gas Leases

MMS properly required the lessee of a Federal offshore oil and gas lease to review royalty accounts and to conduct a restructured accounting to determine the extent to which demand charges had been excluded from gross proceeds for royalty purposes.

APPEARANCES: Robert E. Holden, Esq., George J. Domas, Esq., New Orleans, Louisiana, for Appellant; Geoffrey Heath, Esq., Howard W. Chalker, Esq., Office of the Solicitor, U.S. Department of the Interior, for the Minerals Management Service.

OPINION BY ADMINISTRATIVE JUDGE PRICE

Murphy Exploration and Production Company (Murphy) has appealed from a July 11, 1996, Decision of the Associate Director for Policy and Management Improvement, Minerals Management Service (MMS), denying Murphy's appeal from an Order to pay royalties on "demand charge" proceeds and to conduct a restructured accounting (Order). The Order, issued November 5, 1993, by the Dallas Area Audit Office, MMS Royalty Management Program (RMP), was the result of an audit of Murphy's royalty payments on Federal and Indian leases from January 1, 1988, through December 31, 1992. The RMP concluded that Murphy owed additional royalties in the amount of $496,529.56 for the months tested in the audit (Enclosure 1 to Order), and for demand charge proceeds that Murphy received from gas produced and sold from OCS Lease No. OCS-G 6037 and possibly other leases. (Order at 1.) Finding that Murphy's treatment indicated a systemic practice in accounting for royalty, Murphy was directed to perform a restructured accounting. (Order at 4.)

The disputed charges were paid pursuant to two gas purchase contracts executed by Murphy's predecessor-in-interest, ODECO Oil and Gas Company (ODECO) as seller. One contract, dated August 1, 1989, is between ODECO and Transco Energy Marketing Company (TEMCO), an independent gas marketer. The other is a direct gas sales contract dated August 15, 1990, between ODECO and Commonwealth Gas Company (Commonwealth). Both contracts specify a gas unit price comprising two components, a demand charge and a commodity charge. The contracts state that the demand charge is a percentage of a published reference price multiplied by a fixed portion of the monthly volume that ODECO agreed to dedicate to the contract. The contracts likewise state that the gas commodity charge is a percentage of a published reference price multiplied by the actual volume of gas delivered in a month. The RMP concluded that the pricing structure of the two contracts established "a sliding scale price mechanism that results in a lower unit price for taking larger volumes" (Order at 3), in effect a volume discount, which must be included as gross proceeds accruing to the lessee for the disposition of lease production.

Because this appeal concerns a type of charge we have not previously considered, we will set out the relevant contract provisions in full:

The TEMCO Contract

Article I, Definitions:

*   *   *   *   *   *   *

(j) "Delivery capacity" shall mean the average quantity of gas which Seller's well(s) are capable of delivering daily as determined pursuant to Article IV hereof.

(k) "Contract Price" shall mean the price per MMBTU reported for the first week of each month in the Inside F.E.R.C.'s Gas Market Report publication in the table "Prices of Spot Gas Delivered to Pipelines" in the row "Texas" under the heading "Texas Eastern Transmission Corporation" in the column "Index". * * * [Emphasis in original. The contract then lists contingent alternative published references in case the primary publication does not publish the index specified.]

*   *   *   *   *   *   *

(q) "Seller's pro rata share" shall mean Seller's working interest ownership in the deliverable gas in Seller's leases committed under this Agreement.

(r) "Seller's Dedication" shall mean fifty percent (50%) of Seller's pro rata share of Delivery capacity.

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Article IV, Quantity:

1. Subject to the other terms and provisions of this Agreement, it is agreed that Buyer shall have the right to purchase up to Seller's Dedication of the allowable(s) established by the governmental bodies having jurisdiction; provided, however, that such Seller's pro rata share of Delivery capacity shall not exceed 100,000 Mcf [thousand cubic feet] per day. It is expressly understood and agreed that nothing herein shall obligate Buyer to purchase any minimum quantity of gas.

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3. Buyer shall notify Seller of its nomination for any month seven (7) working days prior to the first day of that month. Buyer agrees to release on a month to month basis any gas committed hereunder in excess of Buyer's nomination for such month, as determined by Buyer in its sole discretion.

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8. Commencing with the date of first delivery and during the remaining term hereof, if Buyer's level of takes hereunder is insufficient to protect Seller's leases from drainage by other operators producing gas from other leases(s) covering a common reservoir, then Seller may, * * * request Buyer to take increased quantities of gas to the level necessary to offset such drainage.

*   *   *   *   *   *   *

Article IX, Price:

1. Subject to the other terms and provisions of this Agreement, each month Buyer shall pay Seller the Demand Charge set forth in Paragraph (a) immediately below. Additionally, for all gas quantities delivered under the terms of this Agreement, as determined on the measurement basis set forth in Article II of Exhibit "B" [which describes metering and measurement], Buyer shall pay Seller a Commodity Charge as set forth in Paragraph (b) immediately below:

> (a) Demand Charge equal to A x B, where A equals twenty percent (20%) of one-hundred and seven percent (107%) of the Contract Price and B equals seventy-five percent (75%) of Seller's Dedication, multiplied by the number of days in the applicable month and;
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> (b) A Commodity Charge equal to eighty percent (80%) of one-hundred and seven percent (107%) of the Contract Price multiplied by the volume (MMBTU) delivered to Buyer during such month.

2. The parties agree that if the Contract Price for any month is less than $1.55 per MMBTU then Seller shall have the right to suspend deliveries of all or a portion of its gas hereunder for such month. In the event Seller elects to suspend deliveries of its gas pursuant to this Section 2, Buyer and Seller agree that the Demand Charge shall be suspended during the period of time that deliveries are suspended. If Seller elects to suspend deliveries under this section, Seller shall have the right to sell such suspended gas to third-party purchasers until such time as the Contract Price is equal to or greater than $1.55 pr MMBTU.

The Commonwealth Contract

Article I, Definitions:

1.9 "Daily Contract Demand Volume" (DCDV) shall mean an amount of Gas equal to ten thousand (10,000) MMBtu Day. [Sic.]

The Daily Contract Demand Volume may be reduced pursuant to the provisions of Section 3.8 of this Contract.

* * * * * * *

1.14 "Excess Gas" shall mean any Gas in excess of the Daily Contract Demand Volume which Seller has available for sale and delivery and which Buyer desires to purchase and receive from Seller pursuant to the terms and conditions of Article III hereof.

Article III, Sale and Purchase Obligation:

3.1 During each Month of the term of this Contract, Seller shall make available to Buyer on each Day an amount of Gas equal to the sum of the Daily Contract Demand Volume plus any applicable Fuel Gas.

3.2 Buyer shall give notice to Seller not later than the twenty-first (21st) of each Month as to Buyer's nomination of Gas to be purchased by Buyer from Seller during the following Month. Buyer may, upon forty-eight (48) hours advance notice * * * change such nomination and nominate up to the Daily Contract Demand Volume plus any applicable Fuel Gas for any Day that this Contact is in effect. Seller shall use reasonable efforts to comply with such changed nomination. <u>Any Gas within the Daily Contract Demand Volume not nominated by Buyer</u> by the twenty-first (21) [sic] of the Month, <u>for delivery during the following Month shall be released to Seller for sale to other parties during such following Month</u>.

* * * * * * *

3.8 Buyer and Seller recognize that their ability to perform the several provisions of this Contract may be affected in part by volume rationing at the Delivery Points by the First Transporter. * * * At present Buyer and Seller have been informed that the First Transporter will not accept delivery of more than 5,004 MMBtus of Gas plus Fuel Gas per Day at the Delivery Points for Buyer's Account. <u>Accordingly, the Daily Contract Demand Volume specified in Section 1.9 of this Contract shall be deemed to be 5,004 MMBtu [sic] per day</u>. * * *

Article IV, Supply Warranty:

4.1 <u>Seller warrants that it will have and</u>, subject only to Article XII hereof, that it will <u>maintain</u> throughout the term of this Contract <u>a quantity of gas uncommitted to other purchasers and capable of being delivered</u> to the First Transporter at the Delivery Points for the account of Buyer <u>that</u>

will satisfy on each Day one hundred percent (100%) of the Daily Contract Demand Volume that can be nominated by Buyer under the terms of this Contract. Seller further warrants that it will have and, subject only to Article XII hereof, that it will maintain throughout any remaining term of this Contract a quantity of gas uncommitted to other purchasers and capable of being delivered to the First Transporter at the Delivery Points for the account of Buyer that will satisfy one hundred percent (100%) of any increased Daily Contract Demand Volume that can be nominated by Buyer and that the parties have previously agreed to during the term of this Contract.

4.5 If at any time during the term of this Contract, Seller fails to deliver the Daily Contract Demand Volume * * * Seller will use its best efforts to acquire additional supplies of Gas to satisfy such obligations. Seller warrants that its obligations to Buyer are firm and that to the extent Seller is unable to satisfy fully all of its obligations, Seller will use its supplies of Gas to satisfy fully its obligations under Section 4.1 prior to making sales to other buyer[s] under obligations that are not firm. * * *

Article VIII, Price:

8.1 The Monthly price per MMBtu for Gas furnished by Seller under this Contract shall equal the sum of a Gas Demand Charge and a Gas Commodity Charge.

8.1.1 Any Fuel Gas will be paid for at 100% of the Base Index.

8.2 The Monthly Gas Demand Charge shall be equal to the product of twenty-seven and twenty five one hundredths percent (27.25%) of the Base Index for the Month multiplied by 30.4 and multiplied by eighty percent (80%) of the Daily Contract Demand Volume for such Month. The Monthly Gas Demand Charge shall be reduced by a charge equal to the product of twenty-seven and twenty five one hundredths percent (27.25%) of the Base Index for such month multiplied by the quantity of Gas up to the Daily Contract Demand Volume, expressed im MMBtus, requested by Buyer for delivery in such Month which is not delivered by Seller.

8.3 The Monthly Gas Commodity Charge shall be equal to the product of eighty-one and seventy-five one hundredths percent (81.75%) of the Base Index multiplied by the total number of MMBtus of Gas tendered by Seller and accepted by Buyer during such Month (including Fuel Gas associated with such Gas).

(Emphasis supplied.)

In her Decision affirming the RMP Order, the Associate Director agreed that Appellant had improperly excluded the demand charge price component from the gross proceeds minimum value on which royalty must be computed. The Decision determined that the demand charge is a payment for the disposition of lease production, thus finding the demand charges in this case to be different from the "take-or-pay" payments held to be royalty-free in Diamond Shamrock Exploration Co. v. Hodel, 853 F.2d 1159 (5th Cir. 1988), discussed infra, in that the demand charges are computed as part of the total sales price of produced gas and not as a payment in lieu of production as Murphy argues. (Decision at 9.)

In support of the conclusion that demand charges are not payments in lieu of production within the meaning of Diamond Shamrock, supra, the Decision noted that:

> Rates in the natural gas transmission industry are usually two-part--the demand charge[,] which is based on the actual or estimated peak daily, monthly or hourly usage of the customer, and the commodity charge, which is based upon the volume of gas actually taken by the gas customer. The commodity charge is substantially smaller than the demand charge, hence the larger the volume of gas taken, the lower the unit cost. Atlantic Seaboard Corp. v. Federal Power Commission, 404 F.2d 1268 (D.C. Cir. 1968); Howard R. Williams and Charles J. Myers, Manual of Oil and Gas Terms (9th ed. 1994). The record, as well as industry practice, show a clear and direct connection between the demand and commodity charges in establishing gas purchasing rates. The demand charges were not made in lieu of production.

(Decision at 9-10.) Finally, the Associate Director concurred in the finding that Murphy's practice of excluding demand charges from royalty calculations demonstrated a systemic deficiency that justified further examination and a restructured accounting. Appellant timely brought this appeal. 1/

We recognize, as does MMS, that under Diamond Shamrock, supra, production triggers the royalty obligation. That decision was based on the court's conclusions that

> royalties are not due on "value" or even "market value" in the abstract, but only on the value of production saved, removed or sold from the leased property. Likewise, the agency's regulations do not refer to "gross proceeds" in the abstract, but only

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1/ Appellant requested and was granted an extension of time to file its Statement of Reasons for appeal to this Board from Sept. 13, 1996, until Oct. 14, 1996, which extended the time for finally deciding this appeal by 30 days. Federal Oil and Gas Royalty Simplification Act of 1996, 30 U.S.C. § 1724(h)(1) (1998 West Suppl.). MMS was also granted several extensions of time to file its Answer.

to gross proceeds that accrue to the lessee from the disposition or sale of produced substances, that is, gas actually removed and delivered to the pipeline. Consequently, royalties are not owed unless and until actual production, the severance of minerals from the formation, occurs. [2/]

Diamond Shamrock, supra at 1165. Rather than appealing the decision, when the Department revised its oil and gas valuation regulations, it incorporated the holding of Diamond Shamrock by deleting the reference to take-or-pay payments from the definition of gross proceeds. 53 Fed. Reg. 45,082 (Nov. 8, 1988).

Thus, in its Supplemental Statement of Reasons (SSOR) for appeal to this Board, Appellant argues, as it has before MMS, that the demand
charges are the same as "take-or-pay" payments and that they therefore are properly excluded from gross proceeds. Disputing MMS' conclusion that Diamond Shamrock, supra, is inapplicable, Appellant asserts that the contracts do not compute demand charges as part of the total sales price of produced gas. (SSOR at 5.) To the contrary, it is asserted that "there is no link between the demand charges and any severed gas" (SSOR at 5), because "the amount of the demand charges was determined by the monthly volume that the seller had to stand ready to deliver." (SSOR at 6.) Appellant contends that the Decision's reliance on Atlantic Seaboard Corp., supra, and the definition of demand charge stated in the Manual of Oil and Gas Terms, supra, is misplaced because both contemplate a pipeline rate rather than a gas purchase. (SSOR at 6.) Since the demand charges were made "in consideration for the exclusive commitment of reserves to the contracts" (SSOR at 6-7), and they fulfill the same risk-shifting function as take-or-pay payments, Murphy contends that MMS has failed to supply "the critical missing link `between the funds on which royalties are claimed and the actual production of gas.'" (SSOR at 8.) Despite these contentions, however, Murphy also states that it "has in fact received demand charge payments when there were no deliveries of production under these contracts." (SSOR at 3.)

In its Answer, MMS responds that demand charges are not take-or-pay payments, but an element of the price of gas purchased and taken, which are therefore royalty-bearing. (Answer at 2.) Citing the relevant contract provisions quoted above, MMS characterizes the TEMCO contract as a short-term contract for monthly gas sales with a two-part pricing structure which permits a lower price per MMBTU (one million British

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2/ These conclusions in turn were based on the court's determination that the term "production" could be an "abstract noun" (the act or process of producing) or either of two "concrete nouns" (the products of an oil and gas well or the well itself), and its conviction that Congress did not intend to exclude any of the industry's usages of the term when it drafted the definition of "production" in the Outer Continental Shelf Lands Act, 43 U.S.C. § 1331(m) (1994). Diamond Shamrock, supra at 1166.

Thermal Units) when the purchaser takes higher volumes of gas, i.e., a volume discount that creates an incentive to take higher quantities of gas. (Answer at 2-5.) Furthermore, the TEMCO contract gave ODECO the benefit of a floor price below which it could suspend deliveries to TEMCO and sell gas to third persons, in which case TEMCO would pay neither the commodity nor the demand charge. (Answer at 5.)

The Commonwealth contract is characterized as a short- to mid-term contract for monthly gas sales (Answer at 7), and was similarly structured to allow ODECO to sell gas that Commonwealth did not take to others. The two-part price was designed so that if Commonwealth took 80 percent of its entitlement, the price would be the average spot market price; if it took less than 80 percent, the price would be slightly more than the spot market price; and if it took more than 80 percent, the price would be slightly less than the spot market price. (Answer at 7-8.)

MMS flatly denies that the contracts at issue are similar to take-or-pay payments, for the reasons that there is no minimum take requirement; no requirement to pay for volumes not taken, nor could there be in the absence of a minimum volume requirement; no gas make-up clause because any gas the purchaser failed to take could be released for sale to third persons; and because of the modest amount of the charge, it cannot fairly be said that it was designed to ensure ongoing operations, maintenance, and investment. MMS acknowledges that the sole "possible similarity" lies in the fact that a true demand charge must be paid regardless of whether any gas is taken in the month. (Answer at 14.)

MMS refutes this "possible similarity" by observing that the contract provision was structured with the expectation that gas would be taken, even if volumes fluctuated, otherwise it would make little commercial sense to enter into such a contract at all. (Answer at 14-15.) In response to Murphy's allegation that there are periods in which it received demand charges when no gas was delivered (SSOR at 3), MMS concedes that

> [i]n the rare event that one of the purchasers paid the demand charge component for a particular month and took zero production during that month, no royalty would be due because production is a statutory prerequisite to royalty. But if the purchaser pays the demand charge and takes production, as the contract contemplates, the price the purchaser pays for that production is the sum of the demand charge and the commodity charge.

(Answer at 15.)

Lastly, MMS makes the persuasive point that the commodity charge component of the price is less than the spot market price for natural gas, and thus concludes that the commodity charge cannot constitute the entire sales price, since such a conclusion perforce implies that Murphy was selling gas below market prices. (Answer at 15-16.)

As the Decision frames it, the issue before us is whether the demand charge component of a gas contract price, which is payable regardless of whether there is production, constitutes gross proceeds received for gas produced and sold pursuant to the contract. Appellant, on the other hand, contends that the demand charge is not subject to royalty in any case precisely because it is payable without regard to volumes taken by the purchaser, and that the link to actual production required by Diamond Shamrock, supra, therefore is missing. Before this Board, MMS has argued that the demand charges are not like take-or-pay payments and that Diamond Shamrock, supra, does not govern, yet it is admitted that the demand charge is not royalty-bearing if no production is taken, an apparent acknowledgment that Diamond Shamrock, supra, is applicable.

We begin with the definitions of "demand charge" and "commodity charge." The Manual of Oil and Gas Terms, supra, defines "demand charge" in the following manner:

> That portion of a rate for gas service which is based on the actual or estimated peak daily (monthly or hourly) usage of the customer. [Citation, cross-references omitted.]

(Emphasis added.)

"Commodity charge" is defined as follows:

> A charge for gas based on the gas actually taken by the gas purchaser, as distinguished from a demand charge which is based on the maximum volume a buyer has the right to take, though no gas is taken. The commodity charge is substantially smaller than the demand charge, and hence the larger the volume of gas taken, the lower the unit cost. [Citations omitted.]

We note in passing that in contrasting "commodity charge" and "demand charge," no limitation on the applicability of the latter term to gas sale contracts is expressed or implied.

As stated previously, Murphy is critical of the Associate Director's reliance on Atlantic Seaboard, supra. That case involved an order of the Federal Power Commission authorizing Atlantic Seaboard, a gas pipeline, to impose a special rate for partial requirements customers. The rate was intended to dissuade the customer from seeking gas from a second supplier instead of from Atlantic Seaboard, its historic supplier. Atlantic Seaboard, supra at 1269-70. The demand charge in that case was one of two components of the special partial requirements rate, the other being a commodity charge, which as the court noted, is the typical structure in the industry. Atlantic Seaboard, supra at 1269-70, n.1.

In the pipeline rate context, the demand and commodity components of the rate are the result of allocating and assigning fixed and variable costs. Fixed costs do not vary with throughput, and reflect primarily the costs of creating pipeline capacity and the business structure required to build, maintain, and operate the pipeline system. Variable costs, on the other hand, generally fluctuate with volume. What proportion of fixed costs is to be assigned to the demand component, and what proportion of the fixed costs, if any, is to be assigned to the commodity component is determined during the course of setting pipeline rates:

> The demand component allows for apportionment of fixed costs to those customers who "demand" the right to firm service. Customers must pay for the firm service whether or not they actually use it.
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> *   *   *   *   *   *   *
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> The demand rate typically is a flat monthly charge for each unit of service entitlement generally referred to as "contract demand (CD) or "maximum daily quantity" (MDQ). * * * The term demand rate is generally used for <u>sales</u> service, while a similar rate for <u>transportation</u> service is frequently called a "reservation rate."
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> *   *   *   *   *   *   *
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> [W]hen more fixed costs are classified to the commodity component, the cost of buying a dekatherm or Mcf [thousand cubic feet] of gas (the commodity rate) increases while the cost of the <u>right</u> to use service (the demand rate) decreases.

Sherman S. Poland and Deborah A. Swanstrom, Basic Principles of Structure of Natural Gas Pipeline Rate Proceedings, <u>Natural Resources & Environment</u>, Vol. 6, No. 4 (Spring 1992), at 8-9.

Appellant argues that <u>Atlantic Seaboard</u>, <u>supra</u>, is not applicable because it involves a pipeline rate, and that this distinction is recognized in the definition of a demand charge quoted above. Thus, it is said that "the demand charges here involve a contract, not a rate; they involve a producing company and a pipeline, not a pipeline and its customer; and they allocate risk-shifting for gas well development[,] operating and maintenance costs, not risk-shifting for pipeline costs." (SSOR at 6.)

It appears to us, however, that the term "demand charge" is or can be more generic than Appellant's argument might suggest. Thus, take-or-pay clauses are a type of demand charge:

> A take-or-pay clause guarantees the producer a minimum cash flow in return for dedicating the gas supply to the purchaser. To economists, take-or-pay clauses provide for a type of "demand charge," a charge for reserving an option to use, rather than a "commodity charge," a charge for the quantity of the commodity used. Producers have historically viewed take-or-pay clauses as

> a guarantee of a minimum cash flow and protection against the risk that purchasers will "bank" contracted gas in the ground. Pipelines have seen take-or-pay clauses as a non-price premium for gas commitment.

Similarly, a gas inventory charge, collected by a supplier, is a demand charge for standing ready to supply gas. A reservation fee is also a demand charge for providing firm or guaranteed service. John S. Lowe, Defining the Royalty Obligation, 49 SMU L. Rev. 223, 227, 228 (1996); see also the Manual of Oil and Gas Terms, supra.

We do not perceive how or why the differences between the demand charge in ODECO's sales contracts and the one at issue in Atlantic Seaboard, supra, should affect the basic nature of such a charge. Its two essential features are that it is associated with an option to purchase gas up to a stated maximum (see Article IV of the TEMCO contract; Article III of the Commonwealth contract), and that it is a component of price that is not subject to change or adjustment on the basis of the gas volumes actually taken by the purchaser or customer (see Article IX of the TEMCO contract and Article VIII of the Commonwealth contract). In our view, there can be no serious doubt that the demand charges here at issue are components of the price per MMBTU paid by ODECO's purchasers. Appellant's contracts state as much. The question is whether the fact that the calculation of this element of the price does not depend upon volumes actually taken is an adequate basis upon which to exclude it from the total consideration per MMBTU received by the lessee. Arguing first that the subject demand charges are compensation only for the "exclusive commitment of reserves" (SSOR at 3, 7) and next, that the demand charges are like take-or-pay payments, Murphy contends that Diamond Shamrock, supra, requires a link between the payment and actual production that is absent in this appeal, absent which there is no ground for concluding that the demand charges are royalty-bearing. We cannot agree.

[1] Although a take-or-pay payment is a type of demand charge, not all demand charges are take-or-pay payments. We hold that the demand charges in this appeal are not the same as take-or-pay payments, because the demand charges do not involve long-term contracts, exclusive commitment of production to the purchasers under the contracts, a minimum take requirement, or the right to make-up gas for a specified period, and the amount of the charge is too modest to alone provide revenue for ongoing operations, maintenance, and investment. The single shared characteristic, the obligation to pay regardless of whether any volumes are taken, does not establish that Appellant's demand charges are the same as take-or-pay payments, nor is it necessary to establish that they are the same to come within the ambit of Diamond Shamrock, supra.

As stated, MMS acknowledges that actual production is required to give rise to the obligation to pay royalty. (Answer at 15.) In most of the months examined, production was taken in volumes that exceeded 75 percent of the seller's dedication in the TEMCO contract and 80 percent of contract demand volumes specified in the Commonwealth (Decision at 4), although Murphy claims that there are months in the audit period where demand charges were paid when there were no deliveries (SSOR at 3). 3/ Therefore, to the extent there was production in each of the months examined or to be examined by MMS, the fundamental requirement of Diamond Shamrock, supra, has been met.

For this reason, neither Independent Petroleum Association of America v. Babbitt (IPAA), 92 F.3d 1248 (Fed. Cir. 1996), nor In Re Century Offshore Management Corp. (Century), 185 B.R. 734 (Bankr. E.D. Ky. 1995), avails Appellant, because the facts of both are dissimilar. The former case concerned a nonrecoupable payment in settlement of accrued take-or-pay liability by one purchaser and the subsequent sale of the gas to a substitute purchaser, which led the court to conclude that in such circumstances the lump sum payment is not linked to any gas production, and hence it was not royalty-bearing. IPAA, supra at 1259-60. In the latter case, the lower courts decided that a take-or-pay lump sum buydown payment should be treated like a buyout payment for royalty purposes because the purchaser's payment merely terminated its base contracts and did not constitute a payment for the production sold under the replacement contracts with the same purchaser. They decided that the buydown payment was not subject to the royalty payment. However, that decision was reversed in In Re Century Offshore Management Corp. (Century II), 111 F.3d 443 (6th Cir. 1997) (petition for rehearing pending), with the court's finding that the lump sum payment was akin to an advance payment under a substituted requirements contract, and that the lump sum payment was for production sold. Century II, supra at 449.

[2] Moreover, we are not persuaded that a true demand charge is involved in the case of the TEMCO contract, because ODECO was free to suspend deliveries to TEMCO if the price per MMBTU fell below a certain price, and TEMCO would be relieved of the obligation to pay both the demand and the commodity charges. (Article VIII, sec. 2.) The Commonwealth contract likewise states that price is the sum of the demand charge and the commodity charge formulations, and provides for a reduction in the demand charge for the buyer's monthly nominations that ODECO failed to deliver. (Article VIII, secs. 8.1, 8.2.) Thus, the contracts provided for demand charges that are associated with actual delivery in whole or in part. Additionally, the RMP alleged that the final sales price of the gas was determined

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3/ MMS raises an interesting question regarding Murphy's assertion, noting that the statement could be taken as a representation that one of the purchasers paid the demand charge while taking zero production, or that one of the purchasers took less than the fraction of its volume entitlement on which the demand charge is calculated. (Answer at 15, n.6.) Moreover, the statement admits that there were months in which the charge was paid when production was delivered to the purchaser, as MMS contends. Given Murphy's failure to provide any explanation, detail or evidence to support the contention, MMS' point appears to be well-taken.

at the end of the month in which the volumes were taken when Murphy computed the exact volume of the gas deliveries. (Order at 3.) This was not rebutted on appeal. Furthermore, MMS notes that the commodity charge is less than the spot market price for natural gas, which buttresses our conviction that the demand charge is properly viewed as part of the total consideration received for the volumes delivered. 4/

Finally, Murphy's claim that the demand charge is the consideration for standing ready to deliver is not borne out by the record. Instead, the contracts establish an option to purchase gas reserves that was potentially exclusive above a certain market price. The release provision, coupled with the right to sell the committed gas to others, and the absence of a minimum purchase requirement provision simply do not support Murphy's characterization of the charge. In any event, it strikes us that the distinction between a charge for standing ready to deliver gas production and a unit price for production, of which a demand charge is said to be an element, is a distinction without practical effect where gas actually was delivered. See, e.g., Enron Oil and Gas Co. v. State, DNR, 871 P.2d 508, 511 (Utah 1994), in which a similar argument was made with respect to severance tax reimbursements. In such instances, the demand charge is no more than a formula by which one of two components comprising the price per MMBTU is established, the effect of which, according to MMS, was a volume discount. We note that this allegation concerning the effect of the pricing mechanism also was not rebutted or even addressed on appeal. In short, we think that the record clearly shows that, despite the label and the asserted intent to compensate ODECO only for standing ready to deliver the monthly gas nominations of its purchasers, the demand charges are charges linked to production delivered under the contracts. Accordingly, we conclude that for each month in which gas was taken, the demand charge is part of the total consideration paid to Murphy, and as such, it is royalty-bearing.

4/ For a lengthy commentary and analysis of whether a demand charge should be royalty-bearing, see John S. Lowe, Defining the Royalty Obligation, supra at 264-65, in which it is argued that in jurisdictions following the reasoning of Diamond Shamrock, supra, "pre-production entrepreneurial activities of the lessee," such as sale of production in place, gas inventory charges, reservation fees, hedges and forward trades, should not be subject to royalty because there is no production or sale associated therewith. Noting that current demand charges and production-based bonuses are tied to production, Lowe suggests such payments nonetheless may not be royalty-bearing if the court draws a distinction between the production function and so-called entrepreneurial activities. In his view, a court that does so is likely to conclude that a demand charge or production-based bonus reflects the value of the lessee's commitment or performance. However, Lowe cautions that such reasoning may not be persuasive where the demand charge and commodity charge appear in the same contract clause, as they do in the TEMCO and Commonwealth contract clauses. Indeed, Lowe provides a price clause as an example that is strikingly similar to the clauses here at issue. Id., n.274.

[3] Appellant's lease was issued effective October 1, 1983, subject to applicable offshore gas valuation regulations, 5/ including 30 C.F.R. § 206.150 (1983), which provided: "Under no circumstances shall the value of production be less than the gross proceeds accruing to the lessee from the disposition of the produced substances or less than the value computed on the reasonable unit value established by the Secretary."

"Gross proceeds" for royalty purposes "means the total monies and other consideration accruing to an oil and gas lessee for the disposition of the oil produced." 30 C.F.R. § 206.151; ARCO Oil & Gas Co., 112 IBLA 8 (1989); Pennzoil Oil & Gas, Inc., 109 IBLA 147 (1989); Tricontrol United States, 105 IBLA 392 (1988); Wheless Drilling Co., 13 IBLA 21, 80 I.D. 599 (1973). The gross proceeds minimum value requirement has been sustained as valid. E.g., Marathon Oil Co. v. United States, 604 F. Supp. 1375 (D. Alaska 1985), aff'd, 807 F.2d 759 (9th Cir. 1986), cert. denied, 480 U.S. 940 (1987). For the reasons stated, MMS correctly concluded that the demand charges should be subject to the royalty obligation.

Appellant also objects to the RMP directive to conduct a restructured accounting. Appellant argues that there is no systemic deficiency that would impel a self-audit and it should not have to search for similar charges garnered from other leases or allocable to other time periods on the lease at issue in this case. However, it appears that Appellant systematically excluded demand charges from proceeds on which royalties should be paid. MMS properly directed Appellant to take corrective action by locating the transactions it has treated in this manner. Amoco Production Co., 144 IBLA 135, 138 (1998); W.A. Moncrief, 144 IBLA 13 (1998); Texaco Exploration & Production, Inc., 140 IBLA 282 (1997); Texaco Inc., 138 IBLA 26 (1997).

Therefore, pursuant to the authority delegated to the Board of Land Appeals by the Secretary of the Interior, 43 C.F.R. § 4.1, the Decision appealed from is affirmed.

T. Britt Price
Administrative Judge

I concur:

Gail M. Frazier
Administrative Judge

5/ The gross proceeds minimum value requirement was found at 30 C.F.R. § 250.64 from Oct. 26, 1979, until Aug. 5, 1983, when it was redesignated as 30 C.F.R. § 206.150. Since Jan. 15, 1988, it has been in the product valuation regulations at 30 C.F.R. § 206.152(h) (for unprocessed gas) and 30 C.F.R. § 206.153(h) (for processed gas). The formulation of the rule has remained essentially the same throughout.